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Memorandum for: Mary Ann

Chief/Eura

This is our draft for the DCI for the NSC meeting on Eastern Europe: The Shrinking Market for West European Exports.

Maurice: I think this is a good little paper. How do you propose to get it into the DCI speaking?

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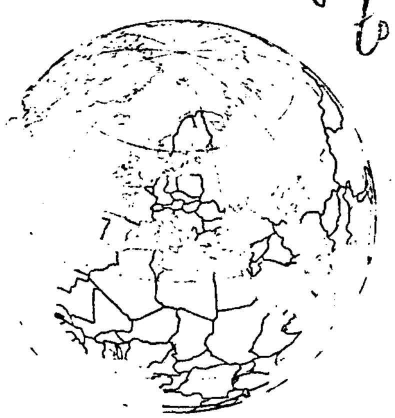
7 July 82



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Eastern Europe: Shrinking Market for West European Exports

Summary

Eastern Europe holds very little promise as a market for West European exports. Severe financial problems are forcing these regimes to slash investment and hard currency imports, resulting in reduced economic growth and stagnating--if not falling--levels of consumption. Most East European countries began to slow the growth of hard currency imports in the late 1970s as debt servicing problems mounted; the collapse of Western bank lending to the region has forced steeper cuts in imports over the past year. Since the financial pressures show no sign of easing and other constraints on economic growth are tightening, East European demand for Western goods will likely continue to slump over the next few years. 25X1

Background

West European exports to Eastern Europe surged during the early to mid-1970s as the East Europeans looked to Western goods to modernize their economies and upgrade living standards (See Table 1). The rising tide of Western imports financed largely by credits supported reasonably rapid rates of economic growth through high levels of investment and rising consumption. The East Europeans had planned to repay credits through improved

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export performance, but systemic inefficiencies coupled with recession and rising protectionism in the West dashed their hopes for strong growth of hard currency sales. Moreover, the East Europeans were caught in a treadmill of needing more and more credit to cover persistent trade deficits and increasing debt service obligations. 25X1

As a result, most East European countries began to retrench in the late 1970s and slowed growth largely through steep cuts in investment. Some tried to sustain or slightly increase consumption levels because of concern over popular unrest (see Table 2). In the cases of Poland and Romania, restraint measures came too late to prevent insolvency and were applied so ineptly that they seriously damaged economic performance. While Bulgaria, Hungary, and Czechoslovakia managed to stabilize their debt positions, the cutbacks--coupled with fundamental economic weaknessess--depressed growth after 1978 to postwar lows. Only East Germany held to a growth policy based on rising hard currency imports and debt. 25X1

Recent Trends

Poland's economic collapse, Romania's financial chaos, and mounting concern among Western lenders over CEMA's creditworthiness resulted last year in declines in hard currency imports for each East European country except Bulgaria. Purchases from Western Europe fell for the first time in more than 20 years. Reflecting the East Europeans' decision to pare investment, the import cutbacks were most severe for machinery, equipment, and industrial materials. The decline in imports has accelerated this year compared with the same period a year ago: Czechoslovakia's hard currency imports are down by 26 percent, Poland's by 43 percent, and Hungary's by 3 percent. 25X1

Financial Crisis Continues

The decline in hard currency imports will almost certainly continue through 1982 and into next year since Eastern Europe's financial crisis shows few signs of easing:

-- Poland's debt rescheduling problems appear even more formidable this year than last. Western governments have suspended talks on debt relief for 1982 and are unwilling to extend further credits. Warsaw is beginning talks with private creditors, but negotiations will be complicated by disorganization, disputes among banks, and disagreement over the amount of debt relief. Even with rescheduling terms similar to last year, Warsaw will still have a financial gap of $2 billion to cover, with little prospect for obtaining the imports needed to support economic recovery.

-- Romania started rescheduling talks with Western banks this January after accumulating some $1 billion in arrearages by the end of 1981. Negotations on rescheduling its official debt also have just gotten underway. Numerous obstacles still must be overcome before any final agreements can be reached. Bucharest's financing requirements, however, are less than half of Warsaw's, and it has the benefit of IMF credits and support. Romania's major problem is to restore the confidence of creditors by demonstrating its ability to manage its external finances more wisely and to take long overdue steps to deal with domestic economic problems.

-- Hungary has nearly exhausted its hard currency reserves and is presently searching desperately for credits from Western banks, governments, the Bank for International Settlements, and the IMF in order to avoid rescheduling this year. Even if Budapest can raise enough funds to meet this year's obligations, some Western bankers fear that a Hungarian rescheduling could prove inevitable next year.

-- Although East Germany has covered its need for trade financing so far through short-term credits, many Western bankers predict that sharply rising debt repayments could provoke a cash-flow crisis by late 1982 or early 1983.

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Trade with the USSR

In addition to the cutbacks in Western credits, Eastern Europe's growth prospects are dimmed by slowing deliveries of energy and raw materials from the USSR. Moscow has already reduced 1982 concessionary oil deliveries to Czechoslovakia, East Germany and Hungary by 10 percent and a further 5 percent reduction appears to be in train. Eastern Europe will be forced to divert more goods to the Soviet market as a result of deterioration in its terms of trade with the USSR and growing Soviet impatience over Eastern Europe's trade deficits. In all likelihood, the USSR will demand more imports of goods otherwise saleable in the West, further reducing Eastern Europe's hard currency import capacity. [redacted] 25X1

Adjustment Measures

Tightening external constraints from both the West and the USSR leave the East European regimes little choice but to impose more severe austerity programs. More cuts in investment and in imports of Western capital goods seem likely, but the scope for such cuts is increasingly limited if the East Europeans are to improve the efficiency and export competitiveness of their economies. Thus, more of the adjustment burden will probably be placed on consumers, but these regimes will be on guard for signs of popular unrest.

-- According to a senior Hungarian banker, Budapest will soon unveil tough measures for improving its trade surplus by a margin large enough to achieve a current account surplus in 1983. In order to free up goods for export, the Hungarian government will cut domestic purchasing power through a 3 percent decline in real wages and reductions in government expenditures;

-- A senior Czechoslovakian trade official has stated that Prague plans reductions in hard currency imports for at least the next two years to counter the Western credit freeze;

-- East Germany is cutting back grain imports and diverting meat from domestic supply to hard currency markets;

-- The East Europeans must offset reduced Soviet oil deliveries through stricter conservation and cutbacks in transportation and industrial activity since they cannot afford large purchases on the world market. [redacted] 25X1

Prospects

Because of continuing financial problems at least through the mid-1980s, the East Europeans will be unable to increase hard currency imports unless they can boost their exports. Although an economic rebound in Western Europe would strengthen Eastern Europe's sales, export growth undoubtedly will be slow. Eastern Europe's major export commodities--chemicals, metals, textiles, and clothing--confront hardening protectionist sentiment in Western Europe and stiff competition from developing countries. Moreover, very few of these regimes are prepared to institute the fundamental reforms needed to improve competitiveness. Without an improvement in borrowing conditions or in export performance, the East Europeans will try to secure imports of needed Western goods by pressing for more countertrade deals. This option has little prospect for success due to continued resistance on the part of West European trading partners to these barter arrangements. [redacted]

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Table 1

EASTERN EUROPE: IMPORTS FROM WESTERN EUROPE

Percentage Change
in Current Prices

	1970-1975	1976-1978	1979	1980	1981
Eastern Europe	24.5	7.6	12.6	5.4	-14.6
Poland	35.3	-1.0	7.4	8.7	-36.0
Romania	18.6	13.0	29.2	-4.4	-20.7
East Germany	17.4	13.6	18.8	2.2	-1.3
Hungary	26.7	17.6	0.7	7.7	-1.0
Czechoslovakia	20.2	7.0	9.5	6.6	-16.5
Bulgaria	26.7	-0.8	13.7	21.9	6.4

Table 2

EASTERN EUROPE: PERCENTAGE CHANGE IN AGGREGATE INDICATORS[a]

Percent

	1978	1979	1980	1981
Poland				
GNP	3.5	-1.7	-3.9	-6.6
Private Consumption	0.5	0.9	-0.5	-0.5
Investment and other outlays	2.8	-8.3	-12.4	-19.6
Romania				
GNP	4.7	3.8	-1.7	1.0
Private Consumption	4.9	4.8	2.7	1.0
Investment and other outlays	4.9	2.6	-7.8	1.1
East Germany				
GNP	1.8	2.7	2.4	2.4
Private Consumption	2.1	2.1	1.5	1.5
Investment and other outlays	-4.8	-1.4	6.4	4.8
Hungary				
GNP	2.7	0.6	0.5	0.6
Private Consumption	3.3	1.3	1.4	2.1
Investment and other outlays	13.7	-14.8	-3.2	-6.2
Czechoslovakia				
GNP	1.7	3.7	1.7	0.1
Private Consumption	2.8	-0.1	-0.4	1.0
Investment and other outlays	-3.2	-2.3	3.9	-2.6
Bulgaria				
GNP	2.1	3.6	-2.8	3.0
Private Consumption	1.7	1.9	0.8	1.3
Investment and other outlays	-9.6	-1.1	-8.0	-8.9
Eastern Europe				
GNP	2.7	1.0	-0.6	-0.9
Private Consumption	NA	NA	NA	NA
Investment and other outlays	NA	NA	NA	NA

a Western estimates. "Investment and other outlays" is a residual value calculated by subtracting from the value of GNP the values of private and government consumption, and the export surplus (or adding the import surplus). The residual encompasses gross investment, science, defense, and other elements of government consumption.

Table 3

EASTERN EUROPE: BALANCE OF PAYMENTS WITH NON-COMMUNIST COUNTRIES

Billions of Current Dollars

	1971	1975	1979	1980	1981[a]
Poland					
Trade Account	0.1	-2.7	-1.7	-0.7	0.4
Current Account	0.2	-3.2	-2.9	-2.6	-2.2
End-Year Net Debt	1	8	21	24	24
Debt Service Ratio (Percent)[b]	20	30	92	101	193
Romania					
Trade Account	-0.2	-0.1	-1.2	-1.5	0.6
Current Account	-0.3	-0.3	-1.7	-2.4	-0.4
End-Year Net Debt	1	3	7	9	10
Debt Service Ratio (Percent)[b]	33	23	22	25	32
East Germany					
Trade Account	-0.2	-1.1	-1.5	-1.7	-1.4
Current Account	-0.3	-1.2	-1.5	-1.7	-1.9
End-Year Net Debt	1	5	10	12	13
Debt Service Ratio (Percent)[b]	18	25	54	55	64
Hungary					
Trade Account	-0.3	-0.7	-0.2	0.3	0.4
Current Account	-0.3	-1.0	-0.8	-0.4	-0.9
End-Year Net Debt	1	3	6	7	7
Debt Service Ratio (Percent)[b]	15	19	37	30	40
Czechoslovakia					
Trade Account	0.0	-0.1	-0.8	0.0	0.3
Current Account	-0.2	-0.3	-0.9	-0.4	-0.2
End-Year Net Debt	0	1	4	4	4
Debt Service Ratio (Percent)[b]	9	14	22	18	22
Bulgaria					
Trade Account	-0.1	-0.6	0.7	1.0	0.7
Current Account	0.1	-0.7	0.5	0.9	0.6
End-Year Net Debt	1	3	4	3	2
Debt Service Ratio (Percent)[b]	45	33	38	32	36

[a] Preliminary estimates.
[b] Repayments of medium and long-term debt plus interest on net debt as a share of exports to noncommunist countries.